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II. ENHANCING INCLUSIVE GROWTH AND EMPLOYMENT IN SMALL MIDDLE-INCOME COUNTRIES[1]

A. Introduction

1. Despite registering sustained high growth over the past decades, poverty, income inequality, and unemployment remain high in many MICs in SSA. This chapter provides the analytic underpinnings of staff's assessment of the extent to which economic growth has been inclusive in small MICs and the factors that could explain their high unemployment. A key policy lesson that emerges from this analysis is that reducing income inequalities has the potential to lead to significant gains in terms of increasing the duration of growth spells in small MICs. Moreover, policies that lead to more sustained reduction in structural unemployment would help to enhance more inclusive growth.

B. Empirical Analysis

Long-Term Growth Dynamics

2. Although historically growth has been strong in many small MICs in SSA, it has not been sufficiently broad-based. The experiences of these countries' growth dynamics and trends are not uniform reflecting individual country-specific idiosyncratic factors. This said, staff's analysis using a traditional Solow-growth accounting exercise shows that initial high levels of growth in many small MICs in SSA reflect capital deepening with relatively lower contribution from structural reform based total factor productivity (TFP) (Figure 1).[2] [3] As a result, once the pace of capital accumulation decelerated and stabilized at a lower level, the overall growth trend in these economies generally decelerated. Despite high level of unemployment, the contribution of labor to the growth was broadly stable probably reflecting the capital intensive nature of the growth. Another important factor contributing to the growth trends in these countries particularly in the case of Namibia and Swaziland was the high prevalence of HIV/AIDS that negatively affected population growth and labor productivity.

3. Despite the sustained period of growth in GDP per capita for MICs, the growth was not strong enough to lead to a fast transition to high-income status. Comparison of the share of middle-income countries' GDP per capita as a share of U.S. GDP per capita suggests that for most of

[1] Prepared by Ara Stepanyan, Rodrigo Garcia-Verdu, Antonio David, Floris Fernanzo Fleermuys and Patrick Gitton.

[2] The growth accounting results should, however, be treated with some caution given the varying quality of the national accounts data for some of these countries as illustrated by recent revisions to historical GDP data. Cape Verde has not yet been included in the analysis given revisions underway on post 2007 national accounts data.

[3] Mauritius has experienced a similar pattern of its growth development.

the MICs this ratio has been stagnant for a long time (Figure II.2).[1] Although the ratio of GDP per capita in US GDP per capita for some of the small MICs in SSA has increased, the pace of growth was low as seen in other small economies in the Caribbean Islands. In contrast, Chile managed to grow fast enough and long enough to increase the ratio about fourfold (Figure II.2 continued). For small MICs in SSA, it took more than 25 years to increase this ratio by 50 percent. More generally, the analysis by Aiyar and others [2] suggests that many MICs seem to be facing the middle-income trap after experiencing a substantial growth slowdown. The middle-income trap is the phenomenon of hitherto rapidly growing economies stagnating at middle-income levels and failing to graduate into the ranks of high-income as predicted by a conditional convergence framework. Structural characteristics of the economy, outward orientation, the state of infrastructure, financial depth and labor market characteristics could exercise independent effects on such a growth slowdown.[3] The analysis of Aiyar and others shows that MICs face a higher probability of experiencing growth slowdowns than low- or high –income countries. The main factors contributing to this high probability of a growth slowdown in MICs are the level of infrastructure development, degree of regulation, and the size of governments. The extent of government involvement in the economy also hampers the capacity of the private sector to expand. Figure II.2 shows the results of a middle-income trap map for Botswana and Namibia suggesting some risk of a growth slowdown, in contrast to Chile, which is experiencing a relatively faster transition to high-income status.

4. Consistent with past advice in Article IV consultations, to reverse the declining growth trend, existing structural impediments to productivity growth should be addressed. Governments should focus on increasing the quantity of high-quality human capital and reducing the skill mismatch in the labor market through efficient investments in education and health care. Furthermore, given the relatively low levels of financial intermediation, increasing access to finance in these countries could provide an important boost to productivity. Also, the relatively large size of governments in many of these small MICs in SSA, with inefficient state-owned enterprises (SOE), crowds out the private sector and impedes its capacity to grow and innovate. In addition, the occupation of a significant portion of available factors of production by SOEs for low-productive activities, contribute to a low economy-wide productivity, which in turn constrains overall growth.

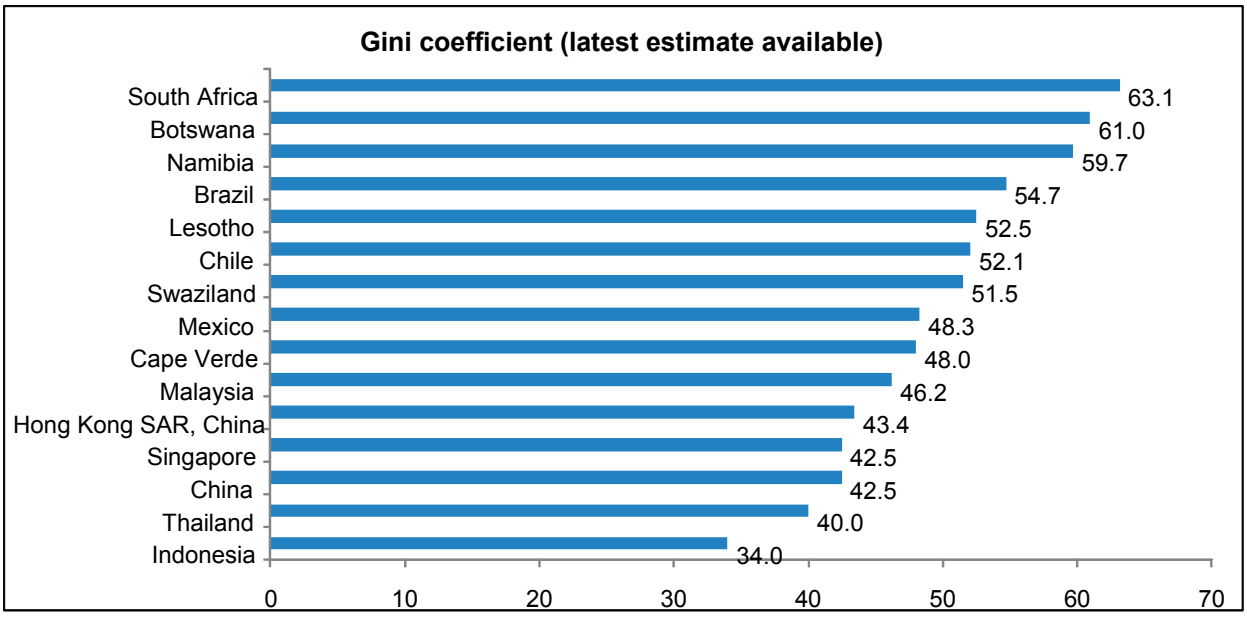
[1] The results are robust to the use of different types of variables representing countries' income, including gross national disposable income per capita.

[2] Shekhar Aiyar, Romain Duval, Damien Puy, Yiqun Wu, Longmei Zhang "Growth Slowdowns and the Middle-Income Trap," forthcoming IMF working paper.

[3] Also Favaro and Peretz (2008) reviewed growth studies in Africa, the Caribbean, Europe, and the Pacific over two periods and found that annual growth among small states slipped by about a ½ percentage point. The growth decline was particularly marked among the Pacific island states, but was also observed in Africa and the Caribbean.

Inclusive growth analysis

5. Many small middle-income countries in SSA continue to face challenges in reducing income inequality. Despite the progress achieved in overall economic development, income inequality in Namibia and Swaziland remains among the highest in the world, and the rate at which inequality has declined in recent years has slowed down relative to earlier periods. For example, while the Gini coefficient in Namibia declined from 0.70 in 1993/94 to 0.6.in 02003/04, the decline slowed to just 0.59 in 2009/10.



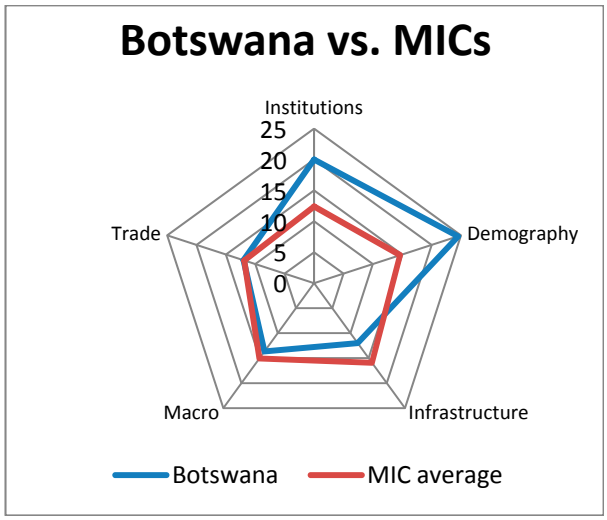
Source: World Development Indicators.

6. Income inequality and unemployment are inextricably linked in small MICs. Given that labor income is the main source of household income, the issue of income inequality is related to the other main challenge facing small MICs in SSA, namely, the high and persistent rate of unemployment. According to the latest national labor force survey data, the unemployment rate remains high at about 11 percent in Cape Verde, 34 percent in Namibia and 29 percent in Swaziland.[1] Youth unemployment statistics are even higher than the national unemployment rates in these small MICs (Box 3), thus creating a major policy challenge for governments in these countries.

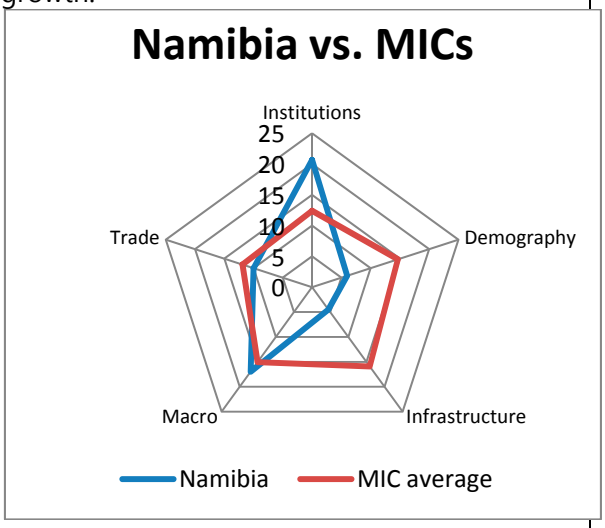
[1] The quality of labor market statistics vary across countries. In the case of Namibia, there are various estimates of the unemployment rate. The latest national labor force survey (2008) found the unemployment rate to be 51.2 percent (broad definition) and 37.6 percent (strict definition). The income and expenditure survey (2009/10) found unemployment to be 33.8 percent (broad definition) and 22.1 percent (strict definition).

Figure II.1. Selected Small MICs—Growth Drivers

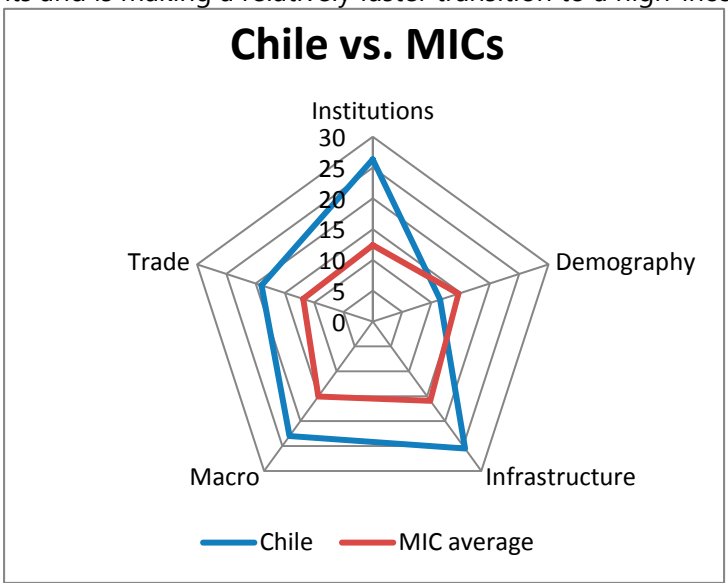
Botswana is relatively strong on institutions compared with other MICs, notably its management of natural resources.....



....and although Namibia has somewhat similar strength in terms of institutions, other productivity growth drivers such as demographics pose some risks for potential growth.



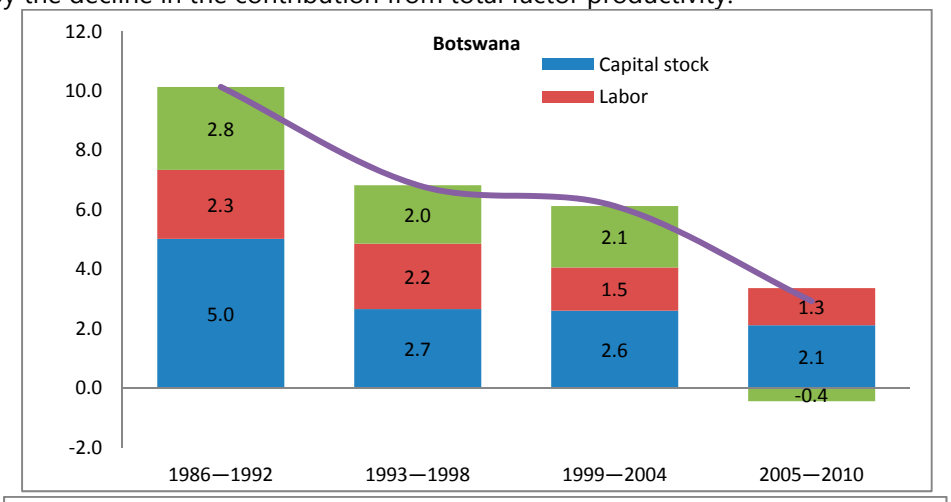
In contrast, Chile outperforms the average MIC in almost all dimensions of growth-promoting determinants and is making a relatively faster transition to a high-income status.

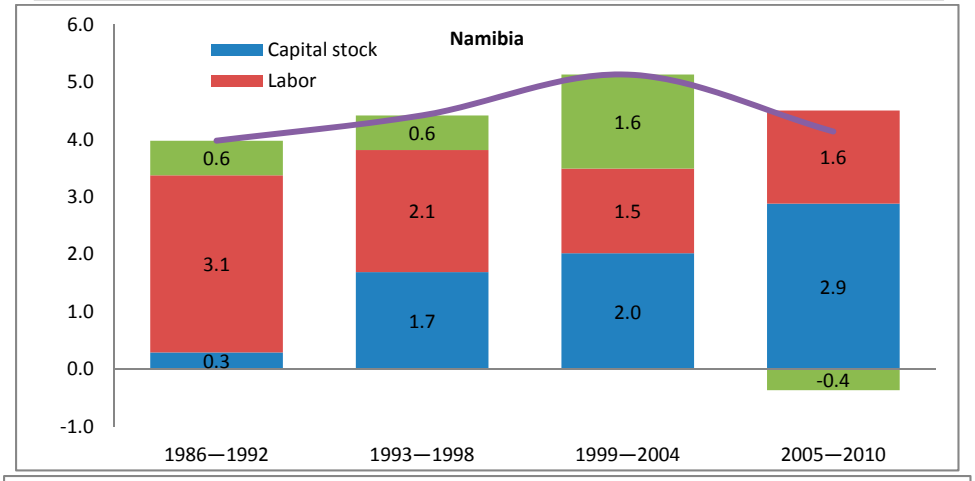


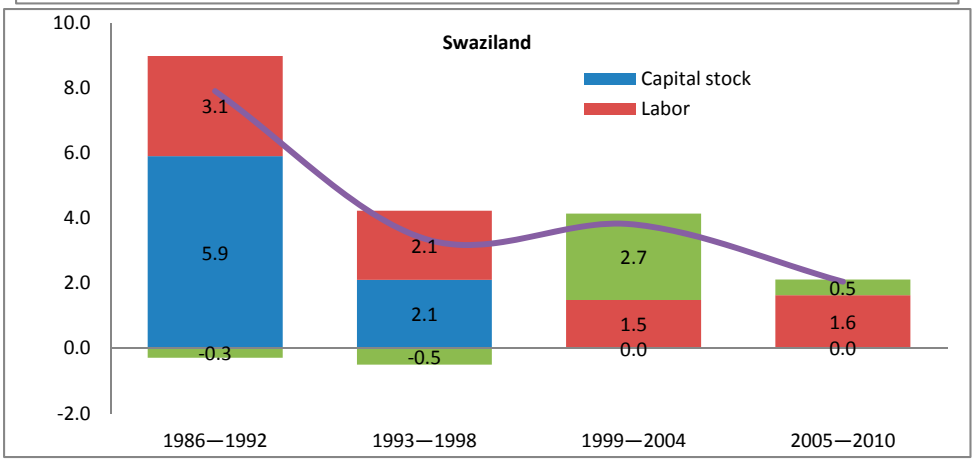
Source: World Bank and World Development Indicators.
Institutions refer to government size, rule of law and regulation; trade refers to regional integration, GDP weighted distance with trading partners; macro refers to gross capital inflows, investment to GDP ratio, trade openness; Infrastructure refers to telephone lines, power generating capacity and demography refers to age-dependency and gender ratio.

Figure II.2. Selected Middle-Income Countries in SSA: Traditional Solow-Growth Accounting

The deceleration in the rate of capital accumulation amplified by declining total factor productivity, led to a decline in trend growth in Botswana and Swaziland. In the case of Namibia, the recent decline in growth was driven by the decline in the contribution from total factor productivity.



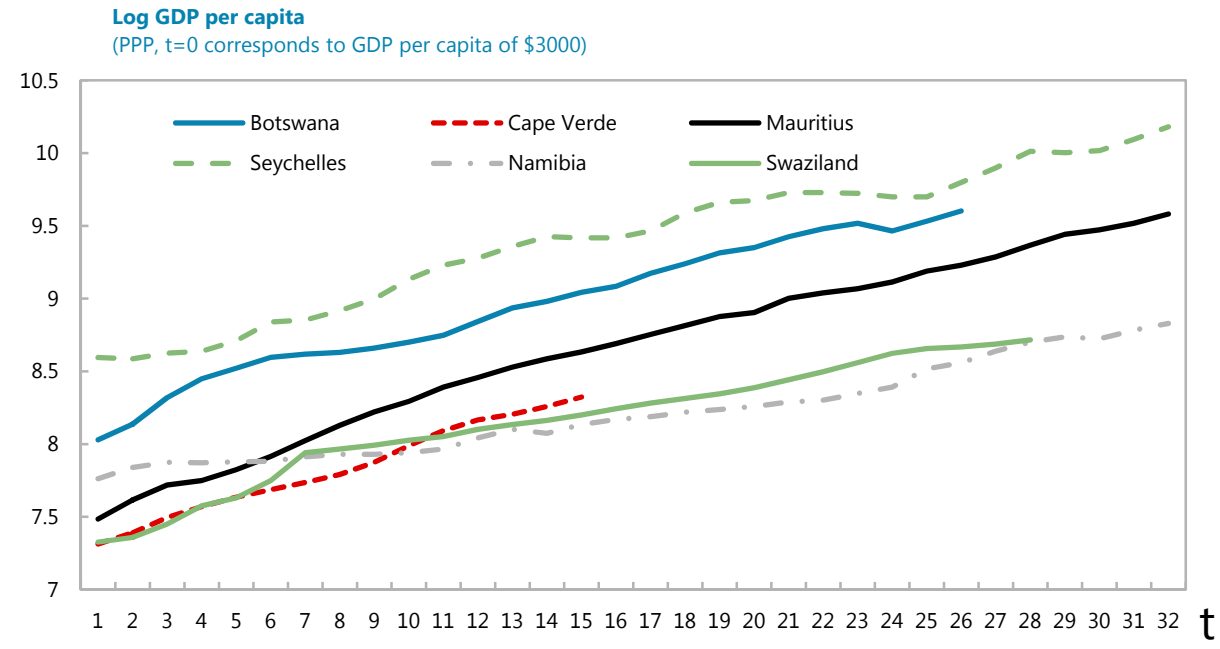




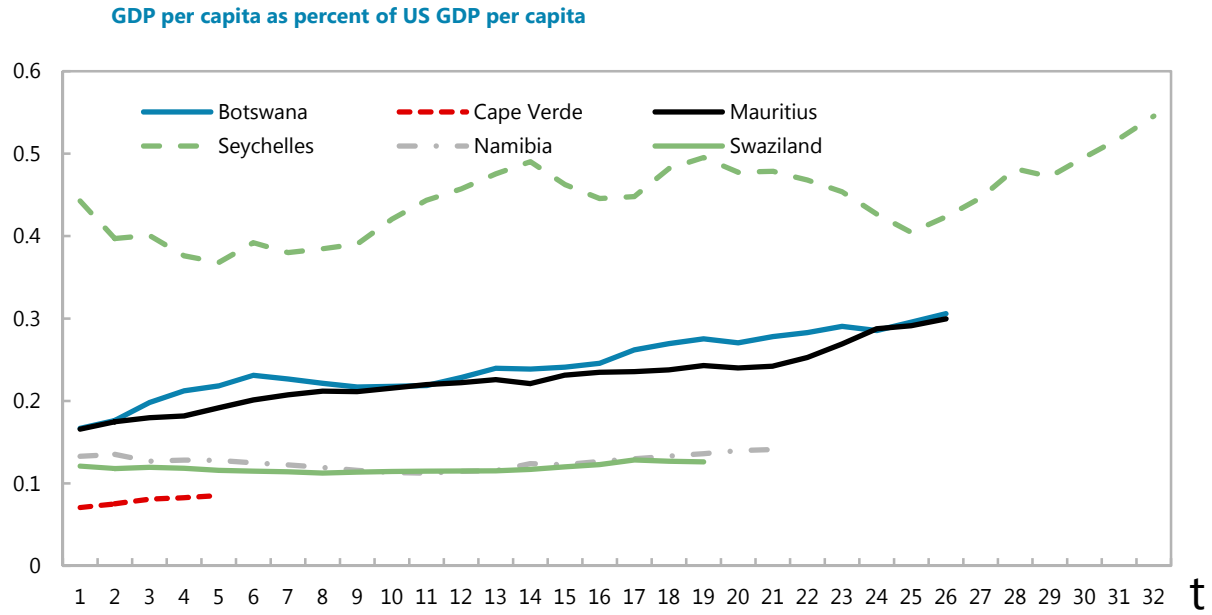
Sources: World Development Indicators and IMF staff estimates.

Figure II.3. Evolution of Per Capita GDP (PPP terms)*

Despite sustained period of growth in GDP per capita for small MICs in sub-Saharan Africa….



….the growth was not strong enough to escape from the middle-income trap as their GDP per capita stagnated as a share of US GDP per capita.

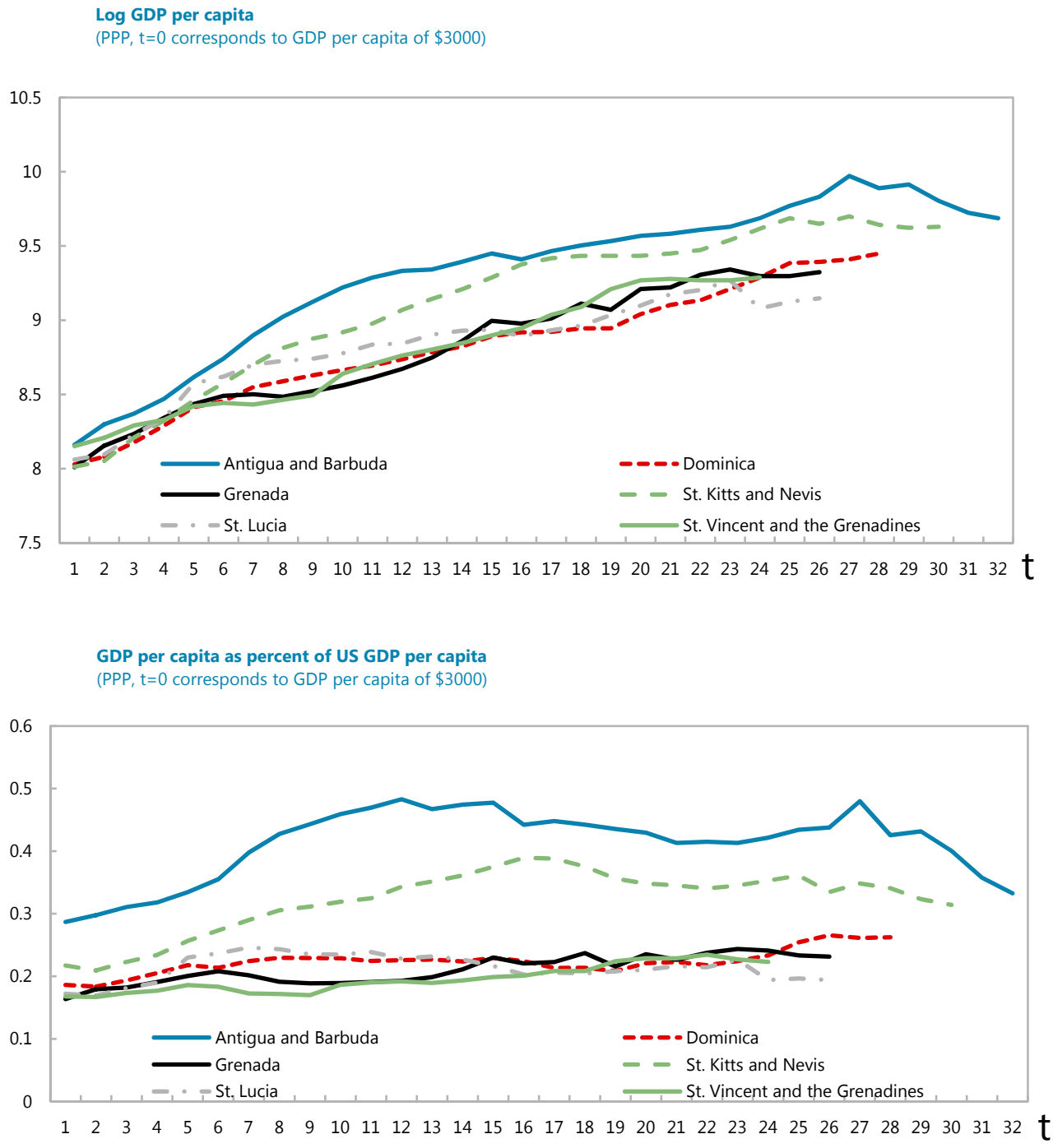


Source: World Bank World Development Indicators

* t=0 is defined as the year when GDP per capita for a particular country reached US$ 3000 in PPP terms or the earliest data available if the starting value is already higher than 3000.

Figure II. 3. (continued): Evolution of Per Capita GDP (in PPP terms)*

The experience of countries in the Eastern Caribbean Currency Union is broadly similar to small MICs in sub-Saharan Africa.

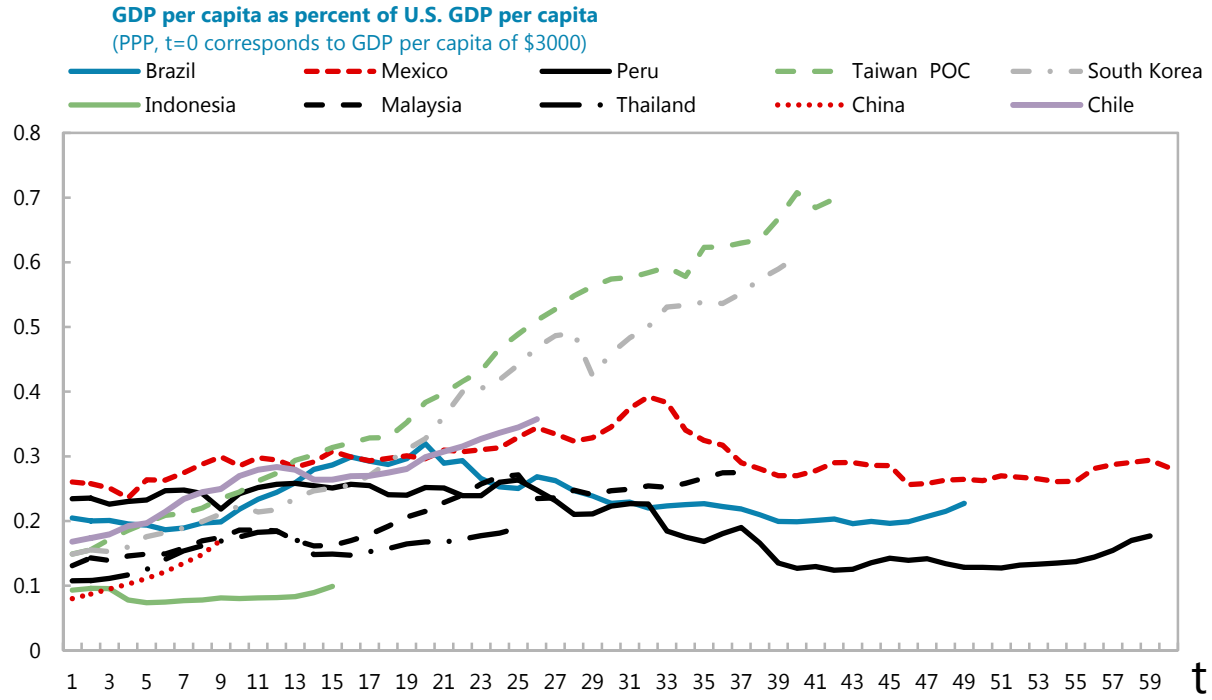


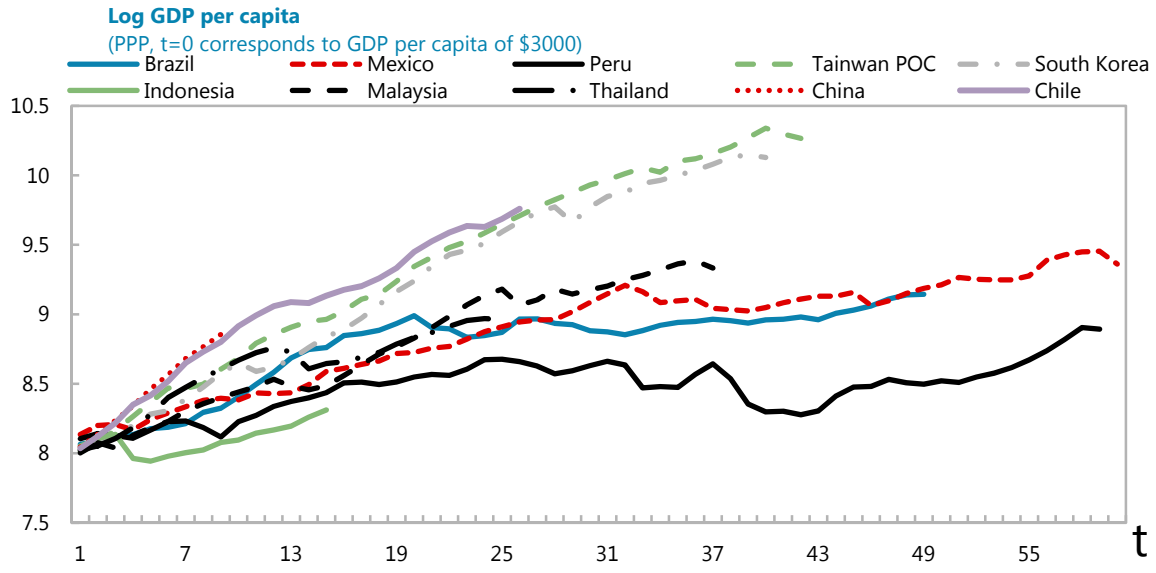
Source: World Bank World Development Indicators

*t=0 is defined as the year when GDP per capita for a particular country reached US$ 3000 in PPP terms or the earliest data available if the starting value is already higher than 3000.

Figure II. 3. Evolution of per capita GDP (in PPP terms) (concluded)

While countries such as Chile have registered both growth acceleration in log income terms as well in share of US GDP per capita and made some progress toward transitioning to high-income status.





Source: IMF staff calculations.

7. Thus, one of the key challenges facing many small MICs in SSA is how best to sustain high growth, while decreasing income inequality and unemployment. Thus, this section of the chapter draws upon previous studies to answer the following three questions: (i) what has been the incidence of growth in small MICs? (ii) to what extent has growth been inclusive in recent decades in small MICs? and (iii) what would be the impact of reducing income inequality on the lengthening of growth spells in these countries?

8. The methodology that was used in Chapter 2 of the Fall 2011 Regional Economic Outlook (REO) for sub-Saharan Africa is applied here to assess the inclusiveness of growth in Namibia and Mauritius.[1] In particular, we estimate growth incidence curves for real expenditure per capita and compare them with those of the previous survey (i.e., between 2003/04– 2009/10 for Namibia and 1996/1997–2006/2007 for Mauritius). Using this analysis, we make an assessment of the incidence of growth and the extent to which growth over the period has been inclusive.

9. The results suggest that compared to other African countries analyzed by the IMF (2011), overall Mauritius and Namibia have performed relatively well. Figures II.4-6 show estimates of the growth incidence curves of real consumption per capita for the period 1993/1994–2003/2004 and 2003/2004–2009/2010, respectively for Namibia. Comparing the two figures it is apparent that there has been a slowdown over time in the growth in mean consumption per capita (green line), which is consistent with the slower economic growth rate of real GDP.

10. The estimated incidence curves suggest that growth has become somewhat less inclusive in recent years. Specifically, although growth has continued to benefit most of the population in Namibia, the shape of the incidence curve shows that over time it has become significantly less pro-poor or less inclusive in the relative sense. This is supported by the fact that poorer households, while continuing to experience positive growth, are no longer experiencing higher growth than households with higher consumption per capita. The pattern of growth of consumption per capita in 1993/1994–2003/2004, in which poorer households experienced faster growth than households with higher consumption per capita, is consistent with the rapid decline in income inequality: the Gini coefficient declined from 0.701 in 1993/1994 to 0.603 in 2003/2004. In 2003/2004–2009/2010, however, this growth pattern was largely lost (except that households in the highest decile of the distribution experienced lower growth than the rest), consistent with the modest reduction in the Gini coefficient, which declined marginally to 0.5971 in 2009/2010.[2]

[1] Analysis of growth incidence curves requires more detailed micro data of two comparable household surveys; at this stage the staff does not have such a detailed micro dataset for both Cape Verde and Swaziland.

[2] An alternative country-specific interpretation of the growth incidence curves would argue that the relative boost of consumption per capita of the poorest groups of the economy during the early years just after independence reflected the Namibia government's targeted effort to address the less-inclusive pre-independence regime. More recently, however, a strong growth of the Namibian middle class, with more flexible budget constraints than the very poor, has marginally increased the middle class relative position vis-à-vis the low income class in terms of consumption per capita growth. A rising middle class could bode well for long-term growth. The analysis also depends on the marginal propensity to consume and save which could vary across the various income brackets.

Figure II.4. Namibia: Growth Incidence Curve of Real Consumption per capita: 1993/1994–2003/2004

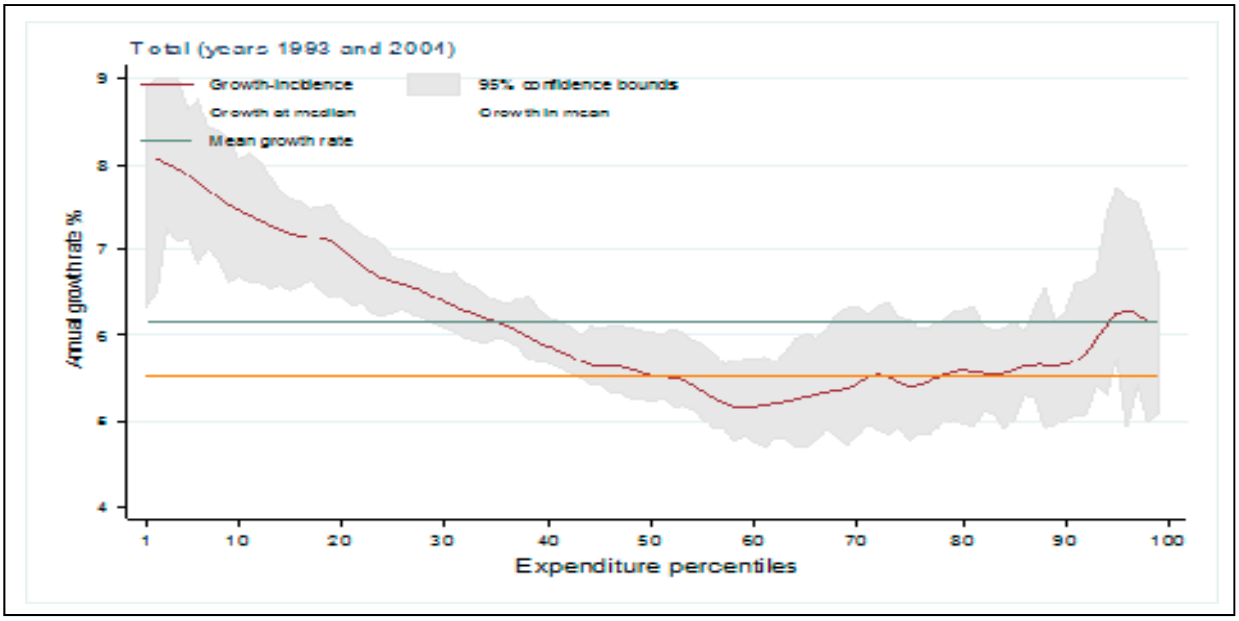
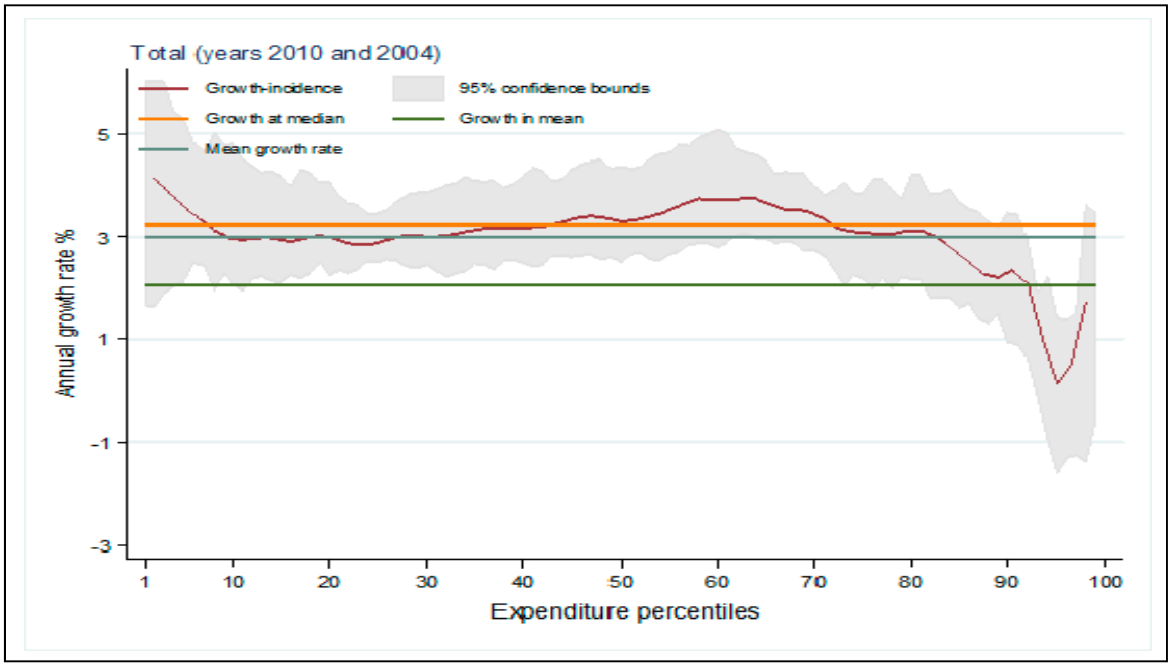


Figure II.5. Namibia: Growth Incidence Curve of Real Consumption per capita: 2003/2004–2009/2010



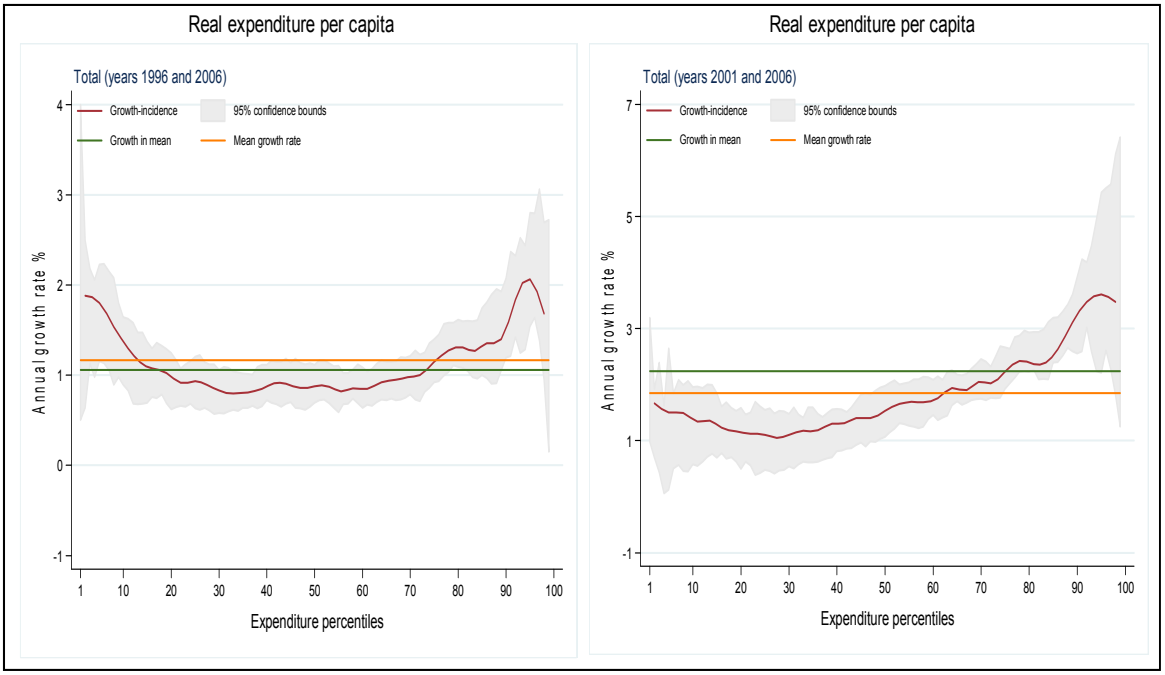
Sources: Country authorities and IMF staff estimates.

11. The less inclusive growth could suggest that government expenditure has become less progressive in recent years. This could reflect either weaker targeting or leakage of social programs and expansion of expenditure in non-inclusive programs. While testing this hypothesis

requires detailed disaggregated data on income by source (labor earnings, rental income, pensions, social transfers, etc.)[3], further reductions in inequality are proving more difficult. This should be a source of concern because the level of inequality in Namibia is still among the highest in the world.

12. For Mauritius all groups have experienced positive growth in expenditure per capita in real terms when comparing the different waves of the surveys (Figure II.8). When one considers data from the 1996/1997 survey compared to the 2006/2007 survey, it is clear that both the poorest percentiles and the richest percentiles have experienced growth well above the mean (both in terms of the growth rate in mean and mean growth rates). Nevertheless, when one compares the 2001/2002 survey with the latest survey, richer groups have experienced higher growth in expenditure, pointing to a more unequal distribution of the benefits of growth in recent years.[4]

Figure II.6. Mauritius: Growth-Incidence Curves for Per Capita Household Expenditures



Source: CSO-HBS Surveys; and authors' estimates.

[3] Future work will use such a detailed disaggregated dataset to assess the robustness of this result.

[4] For Cape Verde, data provided by the authorities show that the Gini coefficient declined from 0.55 in 2002 to 0.48 in 2010. Cape Verde's human development index is the 5th best in sub-Saharan Africa reflecting the government's efforts on social protection and social spending over the years.

Table II.1. Contributing Factors to the End of Growth Spells in the SACU Region[1]

	Spell Dates		GDP per capita growth		Hazard Ratio	Contributing factors (Percent of total hazard)					
	Start	End	During Spell	Next decade		Inequality	Low FDI Inflow	Increased External Debt	More Autocracy	Over-valuation	Trade openess [4]
Botswana	1968	1988	8.3	1.9	0.7	67.5	0.0	0.0	0.0	5.8	14.1
Lesotho [2]	1972	1978	4.9	2.6	7.5	48.0	0.0	0.0	24.5	0.0	20.2
Lesotho	1992	1998	5.6	1.4	3.5	71.5	0.0	0.0	0.0	0.0	28.1
Namibia [3]	1995	...	2.2	...	2.6	72.5	0.0	0.0	0.0	0.0	24.6
South Africa [3]	1998	...	3.0	...	2.6	73.0	9.9	0.0	0.0	0.0	0.0
Swaziland [2]	1971	1979	7.2	-0.2	7.4	45.2	3.2	0.0	26.4	0.0	17.2
Swaziland	1985	1990	4.6	2.2	6.3	42.8	0.0	0.0	35.6	0.0	18.1

Source: IMF Staff estimates and computions.

[1] Growth spells, hazard ratios, and contributing factors, are based on a minimum duration of 5 years, with a p-value of 25 (see Berg, Ostry, and Zettelmeyer, 2012). The contributions are rescaled so that they would sum to 1 if all factors were included. Shown here are only the main factors for these particular observations.

[2] In the case of Lesotho and Swaziland, two separate growth spells have been identified.

[3] In the case of Namibia and South Africa, the growth spell periods are ongoing, while statistical procedure was able to detect the upbreak. In these two cases the hazard of spell ending was estimated as hypothetical in the end of the sample, i.e. 2006.

[4] Trade openness is measured 0 when high trade barriers exist, and 1 when economy is fully integrated to the world trade and has no restrictions. The results suggest the contribution of trade restrictiveness on the probability of spell ending. For example, South Africa, which has trade fully liberalized, had seen no impact from trade restrictiveness.

13. Lowering income inequality has a potential to lengthen growth spells. [5] Basdevant, Benicio, and Yakhshilikov (2012) applied the results of the empirical model of correlates of duration of growth spells developed by Berg and Ostry (2011) and Berg, Ostry, and Zettelmeyer (2012). The results show that income inequality, as measured by the Gini coefficient, is one of the main determinants of the duration of growth spells in SACU. They show that growth spells could be lengthened significantly if income inequality were to be reduced. Specifically, in Namibia, the duration of growth spells could triple if income inequality was to be reduced to those levels prevailing in a group of middle-income countries with the same level of development.

14. Redistributive policies need to be carefully crafted to avoid a negative impact on work and investment incentives. There are two main considerations to bear in mind when implementing redistributive policies.

- Reducing inequalities in human capital should be at the core of policy intervention aimed at reducing future income inequalities and promoting growth.
- In parallel to promoting human capital investment, innovative policies could also help private sector development, so that new skills available are matched with corresponding vacancies. Otherwise the economy could well be trapped in structural imbalances between labor supply and demand.[6]

[5] Berg, Ostry and Zettelmeyer (2012) define growth spells as periods of real GDP per capita growth of at least 5 years, identified as beginning with an upbreak of per capita growth in excess of a minimum of 2 percent and ending wither with a downbreak followed by a period of an average growth of less than 2 percent, or simply the end of the sample.

[6] The cost of public intervention would nonetheless need to be carefully assessed. Public systems can be very costly (e.g., programs of education for all), in terms of buildings, teachers trainings, and overall cost for the budget. Therefore, caution would need to be excercised to mitigate fiscal risks and facilitate quality goals.

Unemployment issues

15. According to Leigh and Flores (2012), the high unemployment rate in SACU, reflects structural rather than cyclical factors. Structural factors here include the skill mismatch in the labor market; low effective cost of capital which tends to bias production toward capital intensive sectors; and wage policies in the public sector with rapid wage growth above productivity increases.

Unemployment and growth—employment-output elasticity

16. Thus, one key policy question is, whether small MICs can grow their way out of their unemployment problem. This assumes that unemployment is largely a cyclical rather than structural. Staff's estimates of the employment-output elasticities for selected small MICs in sub-Saharan Africa using the equation below show that the employment-output elasticity $\boldsymbol{\beta}$ averaged about 0.35 while the constant term $\boldsymbol{\alpha}$ was consistently negative in the estimated panel regressions. The latter result, which was found to be robust, based on additional experiments that dropped countries from the baseline sample, is significant because it suggests the role of other factors in employment creation beyond GDP growth.

$$log(employment)_{it} = \alpha + \beta log(real\ GDP)_{it} + \varepsilon_{it}$$

17. The other question is to what extent does the low cost of capital influence labor market outcomes in small MICs? Specifically, whether the roles of capital and labor in small MICs have been distorted over the years as large sections of the population have been excluded from economic activity and production has become more capital intensive given the low cost of capital. Figure II.7 shows that the lower the cost of capital, the higher the unemployment rate in small MICs. Thus, the implicit bias of some policies in many small MICs (including the tax incentive regime) toward capital-intensive sectors need to be carefully reviewed and addressed to mitigate their impact on job creation.

18. Overall, therefore, our empirical results suggest that structural distortions may be contributing to the persistently high unemployment rate in small MICs. This reflects the highly significant intercepts in the estimated panel regressions coupled with the low effective cost of capital in small MICs**.** This could also explain why the labor market is not clearing in many small MICs in SSA with high wages in the midst of high unemployment. Below we summarize the results of additional experiments aimed at exploring the likely role of such structural distortions in labor markets in small MICs through empirical analysis.

Wage policy and labor market outcomes

19. Our analysis shows that real wage growth in excess of productivity is closely correlated with the unemployment rate in small MICs (Figure II.8).[1, 2] In fact, real wages in excess of productivity gains are significantly large in many small MICs in sub-Saharan Africa. The size of the public sector and higher public sector wage awards do influence labor market outcomes in an economy including the private sector's ability to create jobs. A bloated public sector, which lures job seekers with greater job security and higher wages, tends to distort labor market outcomes, in addition to its impact on medium-term fiscal sustainability.

20. The high real wage growth, which outpaced the growth of labor productivity in many small MICs, partly reflects the outcomes of its centralized collective bargaining framework.[3] Many of the small MICs in SSA have more centralized bargaining framework relative to the median for SSA as a whole. This wage bargaining system not only contributes to the weak link between pay and productivity, but also reduces the response of the real wage to the business cycle fluctuation. Additionally, higher real wage puts upward pressure on labor costs and cause firms to substitute capital for labor, thereby increasing the marginal productivity of labor. In Mauritius, the centralized wage bargaining framework results in wage compression and limits the skill premium, leading to job destruction in the traditional sector and insufficient job creation in the new technology sector (Box II.3).

Union density and unemployment

21. Over the years, unions have played a pivotal role in many of the small MICs in sub-Saharan Africa. Their emphasis on workers' rights is well placed and bodes well for enhancing more inclusive growth. This said, if the job market is mainly dominated by a highly unionized government sector, sometimes this tends to give rise to unemployment in the broader economy (including through insider-outsider effects). The high degree of correlation between unionization and unemployment (Figure II.10) suggests that high union density in many small MICs may be associated with the high unemployment outcomes.[4]

[1] This paper uses the CPI-based real wage measure instead of the GDP deflator-based real wage, while productivity growth is proxied by an adjusted output per capita for the manufacturing and construction sectors. While the authors acknowledge the limitations of this measure of productivity, the latter proxy was used given the lack of reliable data to measure productivity from factor costs based national accounts measure across our entire cross-country sample.

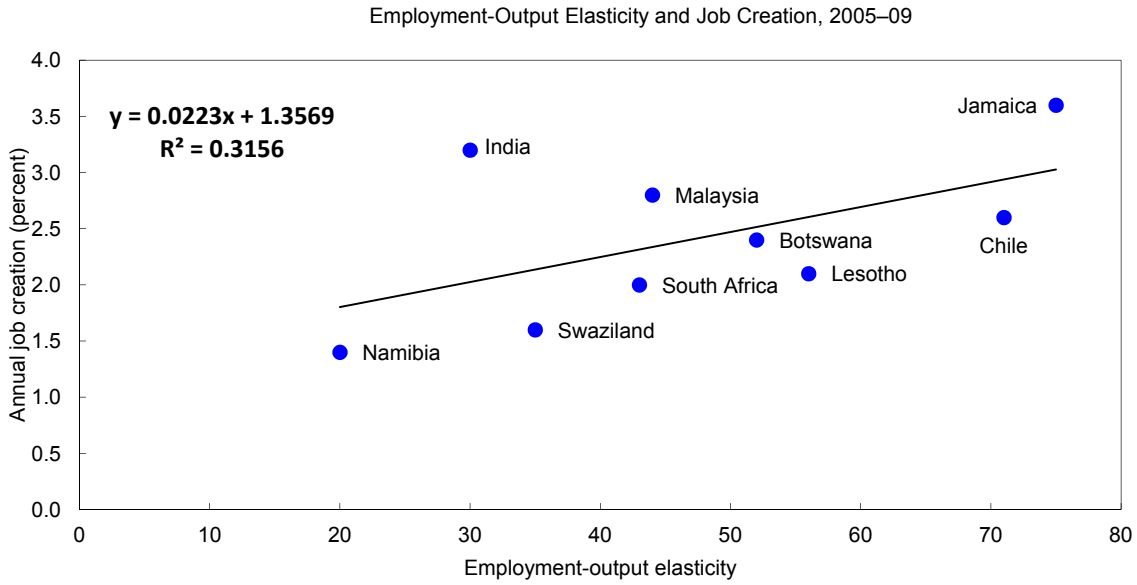
[2] Leigh and Floris (2012) also estimated panel VAR regressions which support these results based on a bivariate correlation analysis.

[3] See supporting econometric evidence in Klein (2012) using micro/industry-level data.

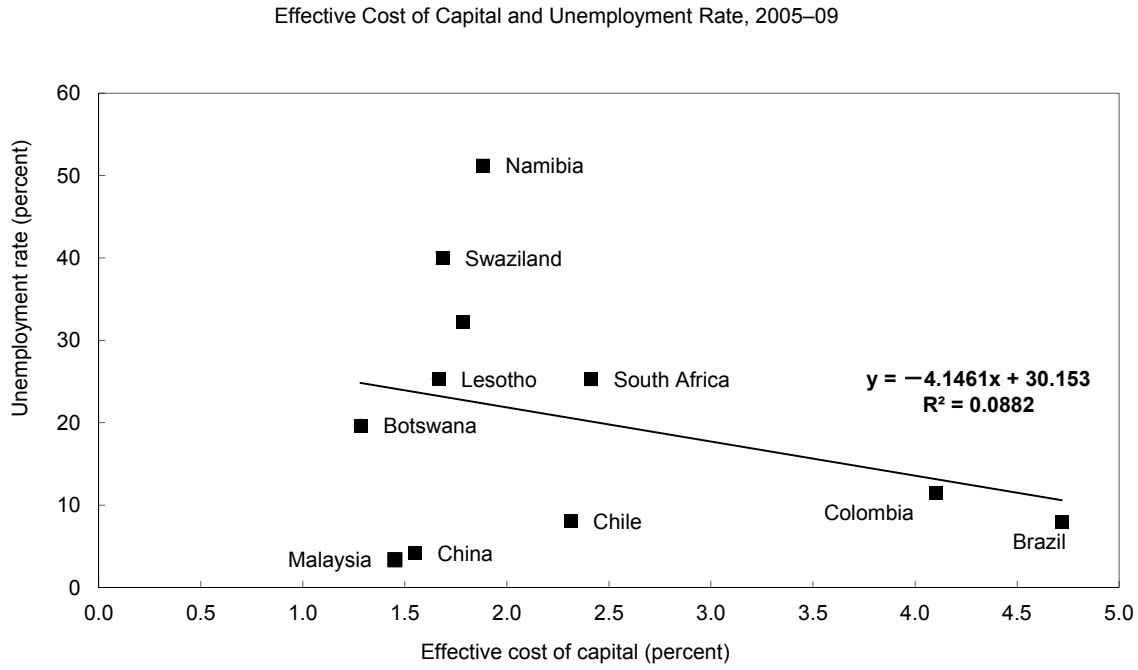
[4] One caveat here is that while Mauritius has a broadly similar level of union density as countries in Southern Africa Customs Union (SACU), it has a significantly lower unemployment rate.

Figure II.7. Employment-Output Elasticity, Job Creation, and the Effective Cost of Capital

Small MICs cannot grow their way out of the unemployment, given employment-output elasticity.



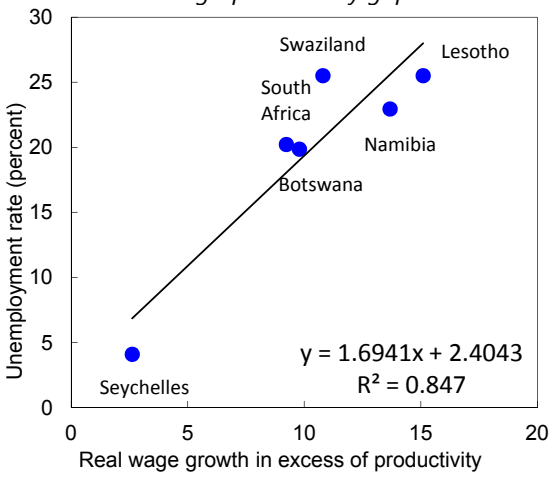
They also have generally lower effective cost of capital, which seems to be associated with high unemployment rates across MICs.



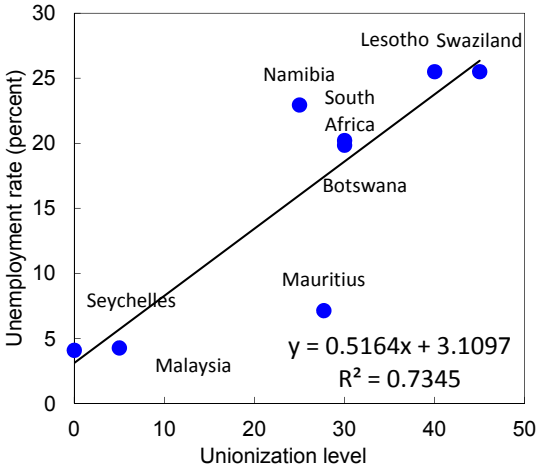
Sources: ILO database; and IMF staff calculations.

Figure II.8. Unemployment Rates and Labor Market Indicators-Correlation Analysis

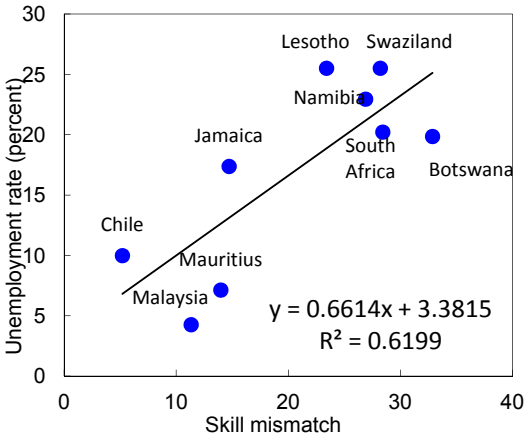
The unemployment rate seems to be positively correlated with wage-productivity gap...



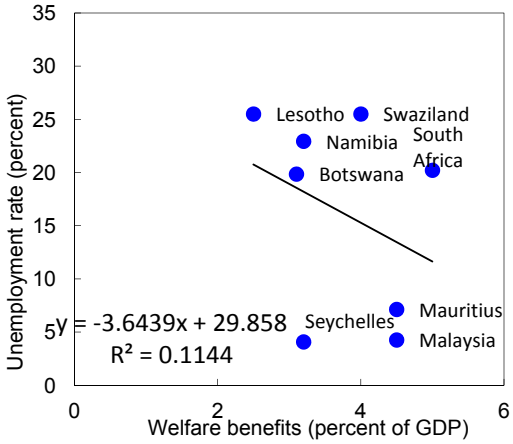
...and positively correlated with union density...



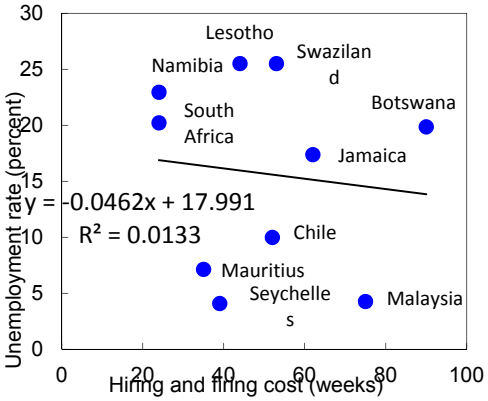
...as well as skill mismatch in the labor market..



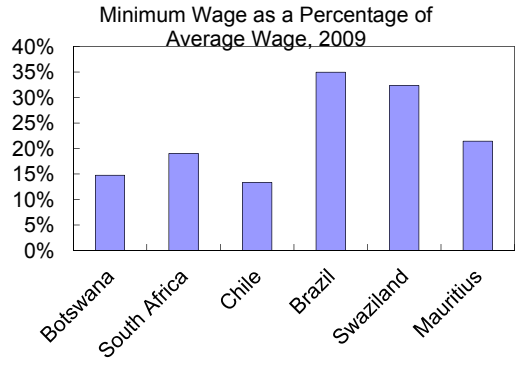
However, the unemployment rate seems have little association with welfare benefits ....



...as well as restrictiveness of labor laws....



while minimum wages remain relatively low.



Sources: ILO database; and IMF staff calculations.

Skill mismatch in the labor market and unemployment

22. Our analysis also shows that skill mismatch is highly correlated with the unemployment rate for some MICs. Our skills mismatch index (SMI) is calculated by taking the difference between the skill demand and supply for each country in the sample. Following Estevao and Tsounta (2011), the SMI for each country i at time t is constructed using the following formula:

$$\mathrm{SMI}_{it} = \sum_{j=1}^{3} \left(\mathrm{S}_{ijt} - \mathrm{M}_{ijt}\right)^2$$

where: j is the skill level; S_{ijt} is the percent of population with skill level j at time t in country i (skill level supply), M_{ijt} is the percent of employees with skill level j at time t in country i (skill level demand).

- *Skill level supply*. We use the World Bank educational attainment data to construct skill level supply using primary education (as low skilled), secondary education (as semiskilled) and college and tertiary education (as high skilled).
- *Skill level demand*. We approximate skill level demand by the percent of employees in three key sectors: construction (to proxy low-skilled workers), manufacturing (for semi-skilled workers) and government and financial services (for high-skilled workers).

23. The results support the basic conclusion that skill mismatch is an important factor that explains unemployment outcomes in small MICs (Figure II.8). [5] Reflecting large spending on education, many of the small MICs generally have a high rate of schooling for primary and secondary education compared to the rest of SSA. However, this high rate of schooling has not yet translated into greater private sector skills because it has produced graduates whose skills are not in demand in the private sector. A high level of tertiary education for a prolonged period would generally enable a country to meet the demands of the private sector and thereby gradually reduce the skill mismatch in the labor market. This type of tertiary education closely mimics specialized advanced education which supplies firms with the necessary high-skilled workers to create more employment.

24. The skill mismatch in many small MICs in SSA calls for aligning the education curricular to the needs of industry. While governments in many small MICs have spent a lot in educating their youth, firms regularly cite the lack of suitable skills among job applicants as a constraint to hiring. Unemployment in Botswana is highest among college graduates, although for South Africa it is the highest among unskilled workers. The former suggests that the education system has not been very successful in producing graduates with marketable job skills. This skill mismatch can be reduced by improving the quality of education spending to support public-private partnerships for skills development, vocational and technical training, information and

[5] While acknowledging the limitations of the skill mismatch measure used in this chapter including its inability to capture the informal sector of the economy and the inherent identification problem involved in the measure, Leigh and Floris (2012) also estimated panel VAR regressions that support the results of this bivariate correlation analysis.

communications technology (ICT) skills, and graduates' internship programs in relevant industries in these economies.

Welfare benefits, labor market regulations, and unemployment

25. Our analysis suggests that welfare benefit spending is not significantly correlated with the unemployment rate in small MICs (Figure II.8). The results are consistent with the findings of Kingdon and Knight (1998) who also rejected the voluntary unemployment hypothesis through the impact of the replacement ratio (benefit-wage ratio) on the unemployment rate. This is an important result that has implications for public policy in many small MICs. If unemployment is not positively associated with welfare spending, then welfare programs can be used to help the unemployed, without fear of the policy leading to an increased unemployment rate.

26. While labor market regulations typically tend to hamper job creation, they are not the key factor that explains the high unemployment rate in small MICs in SSA. Specifically, high level of hiring and firing costs can negatively influence employers' decision to hire new employees. However, Figure II.8 suggests a low degree of correlation between hiring and firing costs[6] and unemployment rates in many small MICs. The estimated panel regressions (Leigh and Floris 2012) also show that hiring and firing costs are not a significant determinant of the overall level of unemployment in many small MICs.[7] The result suggests that the high unemployment rate in many small MICs is not closely associated with labor market rigidities. In fact, minimum wages (as a share of average wages in the economy) in small MICs in SSA are generally relatively on the low side when compared to those in other countries.

27. High levels of structural unemployment in many small MICs have hindered the ability of governments to achieve a more inclusive growth. The analysis in Leigh and Floris (2012) on the link between structural unemployment and income inequality suggests that a sustained GDP growth in small MICs cannot by itself improve income inequality if it is not accompanied by a reduction in long-term structural unemployment. The results show that reductions in structural unemployment substantially improve income distribution. To the extent that better education outcomes in small MICs contribute to a reduction in structural unemployment (as partly inferred from our unemployment-skill mismatch estimated function), they reduce income inequality which has the potential to make growth more inclusive.[8] The policy implication is that for many small MICs and countries with similar structural unemployment-income equality dynamics, policies that lead to

[6] Hiring and firing costs are based on the World Bank's data.

[7] Cape Verde may be an exception here among small MICs in SSA because labor laws are generally perceived as very restrictive and could be playing some role in employment outcomes (Box II.2).

[8] These results are broadly consistent with the results of the growth incidence curves (GIC) in the Regional Economic Outlook (October 2011) for in sub-Saharan Africa which found changes in the coefficients on the level of education are broadly consistent with changes in per capita consumption of the poorest quartile of the distribution for a selected group of economies in the region.

more sustained reduction in structural unemployment would help to enhance more inclusive growth in these economies.

C. Conclusions

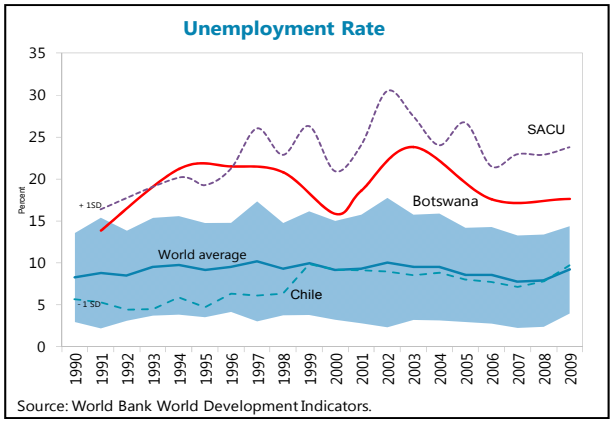
28. Despite the sustained period of growth in GDP per capita for small MICs over the years, the growth was not strong enough to lead to a faster transition to high-income status. More recently, trend growth has also declined in many of these economies. The analysis in this chapter tends to suggest that some MICs in SSA face significant probability of a growth slowdown. The relatively large size of governments in many small MICs in SSA with inefficient state-owned enterprises crowding out the private sector and occupying a significant portion of available factors for low productive activities, contributes to lower economy-wide productivity and thus overall GDP growth. Reversing the declining growth trend would require reducing the size of government and removing the existing structural impediments to economy-wide productivity growth.

29. Relatedly, enhancing more inclusive growth and job creation are key challenges for policymakers in many middle-income countries in SSA. A key policy lesson drawn from the analysis in this chapter is that reducing income inequalities has the potential to lead to significant gains in terms of increasing the duration of growth spells in small MICs. The chapter's analysis of the factors that might have contributed to the high unemployment rate in these countries suggest that while there is some diversity in labor market conditions within these selected MICs, the broad conclusion from the empirical analysis suggest that there is no single measure available to address the unemployment problem in these economies. The analysis suggest that these economies cannot grow their way out of their unemployment problem and only a combination of carefully designed initiatives including prudent government employment and wage policies and measures that address the skill mismatch in the labor market are likely to make significant inroads into the unemployment problem. Furthermore, policies that lead to more sustained reduction in structural unemployment would help to enhance more inclusive growth in these economies.

Box II.1. Botswana and Chile: What Explains the Divergent Unemployment Rates

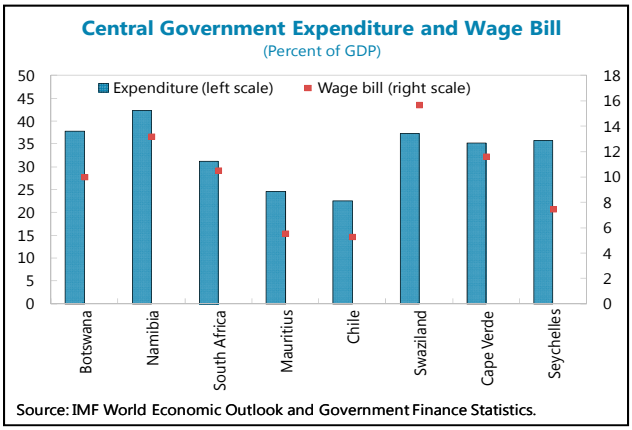
Botswana and Chile are two natural-resource rich economies that are deemed to be success stories for prudent economic management, but with different unemployment outcomes. Both economies are characterized by relatively low inflation, fiscal discipline, institutional strength, good infrastructure and high standards of governance. Despite these similarities in economic fundamentals, Botswana continues to have a double-digit unemployment rate, well above the world average, while Chile has generally kept its unemployment rate below 10 percent (text Chart).

SACU's (including Botswana's) unemployment rate is well above the global average in contrast to Chile's.



Source: World Bank World Development Indicators.

Chile also has maintained a small size of government.



Source: IMF World Economic Outlook and Government Finance Statistics.

What explains this divergence between the two economies in terms of unemployment outcomes?

- Through sound fiscal policy, Chile has reduced the size of the government and has maintained a composition of government spending that favors growth. Public sector wage growth has been broadly in line with economy-wide productivity levels. The limited size of the government and pro-growth government expenditure, suggest that less public sector dominance in Chile might have contributed to private sector led job creation.
- In relative terms, Chile has delivered better education outcomes in terms of quality of its skilled employees compared to Botswana. Chile has over the years made relatively more progress in implementing policies to address the skill mismatch in its labor market. The Chilean labor force is able to perform in a variety of occupations (not only governmental and agricultural sectors). Chile also has a 30 percent enrollment in tertiary education which is high compared to countries in sub-Saharan Africa.
- Unlike Botswana, Chile has made a lot of progress in diversifying its economy away from copper and thereby making the economy more resilient to shocks and limiting the Ballassa-Samuelson effect from the tradable to nontradable sector through wages. In particular, over the years, its service sector has expanded in terms of its share in value added and its share of total employment.

Box II.2. Cape Verde: Unemployment, Education, and Labor Market Institutions

Cape Verde's labor market is characterized by persistently high unemployment, particularly among youth. Total unemployment fell from 20 percent in 2005 to over 10 percent in 2011, while among the youth it fell from 37 percent to over 25 percent (Figure II.11). Part of the decline in unemployment was due to growth and improved employment-output elasticity. Strong economic growth helped to reduce unemployment— output grew 46 percent between 2005 and 2011. Also, employment-output elasticity increased from
0.57 in 1991–1995 to 0.73 in 1999–2003 and from 0.35 to 0.70 among youth in the same period.[1] Nevertheless, persistent unemployment rate above 10 percent reflects also structural features of the labor market most notably the shortage of skilled labor and rigid labor market regulations.

During the past decade Cape Verde has made efforts to improve the skills and quality of its labor force through substantial investment in education. The adult literacy rate has risen from just 37 percent in 1975 to 85 percent in 2008, while gross enrollment in primary education is now more than 100 percent, and two-thirds of students entering the first year of primary school have previously attended preschool programs. Gross enrollment in secondary education is at 70 percent and expanding rapidly. Also, government's Growth and Poverty Reduction Strategy Papers (I and II) included supporting the establishment of several new universities and other post-secondary institutions.

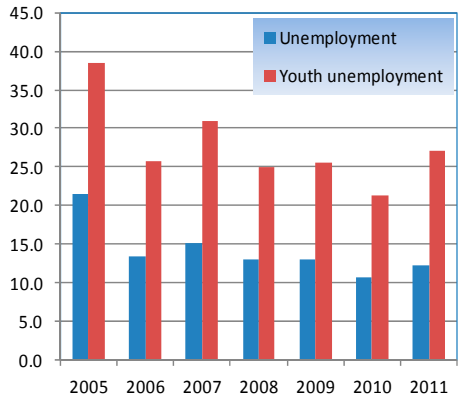
These policies have been broadly successful in improving basic educational indicators. However, much still needs to be done, particularly regarding technical and vocational training necessary to build workforce skills. Most of the population has less than 9 years of formal education, and workers with primary or basic secondary education make up the vast majority of the unemployed (Box text table).

Given that human capital, labor-market institutions are largely responsible for employment patterns in the long run, reforms to the labor-market regulations will be necessary to foster stronger labor demand—particularly in the formal sector—and to make labor markets more flexible to adapt to changing economic circumstances. Although designed to protect workers' interests, Cape Verde's current regulatory structure is among the most restrictive in the world. According to World Bank's Labor Market Efficiency index, Cape Verde's labor market efficiency is among the lowest in sub-Saharan Africa. Its score is 3.75, and it is ranked 30th out of 35 countries. In particular, restrictive hiring and firing regulations have an immediate impact on employment and the flexibility of the labor market. At the same time, the relatively high social security payroll tax reduces incentives to hire low-skilled employees.

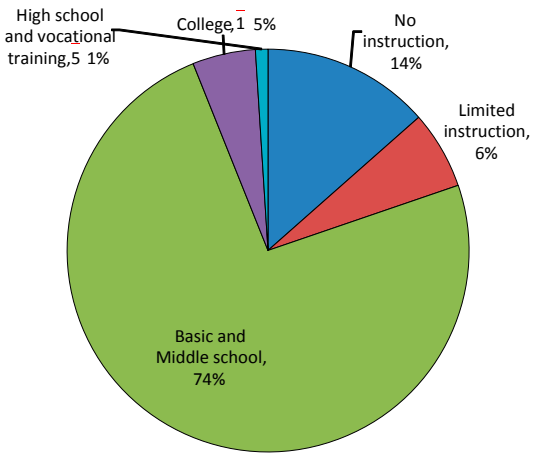
1/ Kapsos, Steven, 2005, "The employment intensity of growth: trends and macroeconomic determinants," International Labor Office, Employment Strategy Papers, 2005/12.

Figure II.9. Cape Verde: Unemployment and Education

Unemployment has declined, but remains high particularly among youth.



*Literacy is high, but opportunities are limited for technical and vocational training**



Source: National Institute of Statistics (INE).

* Official data does not distinguish whether technical and vocational training is included in categories other than "high school and vocational training".

Cape Verde: Education and Unemployment

Education	Unemployed Population
No Formal Education	934
(%)	4.4
Primary Education	8,358
(%)	39.6
Basic Secondary	9,860
(%)	46.8
Advanced Secondary	1,328
(%)	6.3
Tertiary	1,248
(%)	5.9
Total	**21,081**
(%)	**100**

Source: Instituto National de Estatística, Censo 2010.

Box II.3. Mauritius: Unemployment Issues

Can Mauritius grow itself out of its unemployment problem? There has been limited job destruction during periods of economic slowdown, suggesting that cyclical adjustments do not take place through massive labor lay-offs. According to McDonald and Yao (2003), unemployment is largely structural in nature through skill mismatches on the supply side and rigidities on the labor demand side through wage setting institutions and laws. Staff's preliminary estimate indicates a baseline employment-output elasticity of 0.28 percent.

Role of public sector wage policies: For the public sector, the *Pay Research Bureau (PRB)* recommends every five years an increase of the wage bill; the recommendation is 23 percent for 2013. PRB recommendations typically have implications for wage-setting negotiations in the private sector. The wage bargaining process is centralized. The introduction of a *National Pay Council (NPC)* in 2006 has helped link wage growth to productivity advancements, with wages adjustments differentiated across sectors, thereby reducing wage rigidity and containing the wage-price spiral. World Bank (2010) calculated that average annual real wage growth was 2 percent between 2006 and 2009. Real wages grew much faster than labor productivity under the previous regime which linked wage increase to the consumer price index (CPI) only during 2000–06.

Structural aspects of unemployment dynamics: McDonald and Yao (2003) and Porter (2004) argue that rising unemployment has two main causes: (i) a highly centralized wage determination system, which results in wage compression and limits the skill premium, resulting in job destruction in the traditional sector and insufficient job creation in the new technology sector; (ii) the Mauritian education system cannot sufficiently provide to the low-skill-based labor force the higher skills that are needed by the emerging sectors. Growth and competitiveness are being hampered by skill mismatches as Mauritius transitions towards a more knowledge-based economy. The shortage results from an increased demand for skilled labor in the banking, health care, ICT and tourism sectors, relative to the low-skilled textile and sugar sectors. Only 13.5 percent of total primary school entrants obtain their school certificate, which is very low compared to 90 percent of students graduating from primary to secondary education in Mexico, Turkey, and Vietnam (World Bank, 2011). Mauritius needs to introduce drastic measures to increase the scale and quality of its labor force.

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